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SUBJECT: NIGERIA'S ECONOMY ON THE EVE OF ELECTIONS

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Classified By: JOHN CAMPBELL FOR REASONS 1.4 a, b, d

11. (C) Summary: On the eve of elections, from some angles Nigeria's economic performance looks impressive: low debt, high reserves, strong export earnings, stable inflation, GDP per capita up, strong non-oil sector growth, improved budget management, and increasingly modern banking all form the basis for an ever brighter future. Even the most sanguine, however, agree Nigeria faces huge challenges, and that economic reform has not yet delivered higher living standards to most Nigerians. Despite reforms and increased investment, power supply, fuel supply and transport have deteriorated; corruption is severe; state and local governance and the business climate are weak; literacy has fallen, and poverty is deeply entrenched. Reforms in the formal sector have failed to trickle down to the informal sector where most Nigerians make their living, but infrastructure and energy problems have. This disconnect feeds growing public disillusion with the country's leadership. While objectively Nigeria may be better off, most Nigerians do not feel better off.

12. (C) As in politics, Nigeria stands at an economic crossroads. Nigeria's greatest successes, lowering its debt burden and setting aside extra oil earnings, create the temptation to manage resources less prudently. If the next government can begin to deliver more power, reliable fuel supplies, better roads, schools and health services, then broad reforms may be sustainable. Nigeria's economy and the fate of reforms are still highly vulnerable to oil prices. All current reforms occurred in a period of high and rising oil prices. It is by no means given they can be sustained if oil price trends reverse. If a deeper economic impact is not felt in the next few years, then receding oil prices could leave Nigeria even further behind. End Summary.

Behind Every Success

13. (C) One can not look at Nigeria's economy in recent years and not be impressed by what has been achieved. At the same time, one can not look at Nigeria's problems without boggling at the challenges. Nor can one look at the stresses facing

ordinary Nigerians, poor and not so poor, without sharing a little of their despair. It seems every Nigerian economic success has a caveat riding shotgun.

14. (C) Following reform in the banking and financial sector, Nigerian banks are bigger, better capitalized, increasingly modern and sophisticated. They raise both foreign and domestic funds in international markets. Most banks are acquiring foreign partners. They are lending ever more to the private sector, but not, however, to the non-oil sector. On the one hand, a great success, on the other hand very little impact outside the already well-served, and fully internationalized oil sector.

15. (C) There have been improvements in budget management with clearer controls, more transparency, and better discipline. Unfortunately, this applies only to the 48% of funds spent by the federal government and not to the 52% spent by state and local governments. Nor does it apply to the several categories of federal spending that are off budget, such as the government share of oil joint venture financing. Finally, though the management of spending has improved, the quality of expenditure has not yet improved.

Big Success Equals Big Temptations

16. (C) The IMF, a great admirer of Nigeria's reforms, has identified key vulnerabilities that are linked directly to Nigeria's greatest successes -* debt reduction and retained oil earnings. The GON cleared outstanding foreign debt with both the Paris Club of official debtors and the London Club of private debtors. As a result, foreign debt is at a negligible level, less than two percent of GDP. Nigeria's sovereign debt is rated by international debt agencies. Some domestic arrears to pensioners and contractors are being paid. As a result, Nigeria faces intense pressure to go on a

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new borrowing binge. Multi-billion dollar loans for railroads, power plants and other projects are constantly offered and sometimes accepted. The IMF has called for a stringent debt policy and diligent oversight of any new debt to avoid a rapid accumulation of new debt.

17. (C) Similarly, the GON prudently sets aside oil revenue accrued above a set price per barrel in the Excess Crude Account, originally envisioned as a stabilization fund to protect against volatile oil revenue flows. There are no laws or regulations on what the funds can be used for. So far, the GON has spent funds to retire debt, to pay for part of the census, to compensate the budget for a falling oil production, and for power projects. The fund now holds \$9 billion, down from \$14 billion a few months ago. The IMF has urged that formal rules be established on the purposes for which funds can be used and procedures for accessing the funds. Without such rules, it is all too easy to spend down the account for unproductive purposes. Already President Obasanjo has proposed distributing \$4.5 billion, half the current amount, to state governments whose proposals he deems worthy.

Corruption

18. (C) There is a major gap between the international and domestic perceptions of the anti-corruption effort. An astute public relations campaign has garnered widespread kudos abroad for reducing corruption. World Bank President Wolfowitz recently lauded Nigeria's corruption battle and Nigeria jumped 16 places on the Transparency International Corruption Perception Index. Here, most Nigerians think corruption is as bad as ever, and that many anticorruption moves are politically or economically self-interested. Though tighter contracting oversight, more transparent federal budgets and the first oil revenue audit under the Nigerian

Extractive Industries Transparency Initiative (NEITI) are real, government contracting remains rife with corruption and kickbacks; outright theft of public money by state and local officials has increased along with oil revenues; and reforms like privatization often are seen as a way to transfer public property to well-connected insiders. The very few officials prosecuted for corruption got light, if any, sentences. Investigations of other officials have been wielded as pressure to toe the political line rather than to stop corrupt behavior. The President's own actions regarding the Petroleum Technology Development Fund, Transcorp, and the rapid expansion of his poultry farms has raised many questions.

Non-Oil Growth

¶9. (C) Observers often point to three years of strong non-oil sector growth, 8.9% in 2006, as a significant and positive sign of an increasingly diversified economy, which should drive improved incomes and reduce vulnerability to oil shocks. While non-oil sector growth is key, there are real questions about the true level, sustainability, and impact of current non-oil growth. In most countries, several years of 8-10% growth produce spreading, visible, palpable change for the better. This is not so in Nigeria, where a few isolated bright spots contend with deepening gloom elsewhere.

¶10. (C) Agriculture is a big chunk of non-oil growth, but GON policies have not had much impact, and performance is influenced mainly by weather. Good rains in 2005 and better rains in 2006 deserve much of the credit in this sector, and poor rains could see a reversal. Trade, including imports, exports, wholesale and retail trade, is the next largest non-oil sector and has done very well, but owes much to oil revenues. Some service sectors, telecommunications, financial services, and hotels/restaurants, showed strong growth, but are a tiny fraction of GDP. Manufacturing, only 3% of GDP, reportedly grew 10% in 2006. This is hard to square with the fall in manufacturer-reported capacity utilization from about 49% in 2005 to 23% in 2006, mainly due to power shortages; power production itself fell 50%. Some ancillary petroleum sector items are counted as manufacturing and may account for

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the growth. Construction, at 1.5% of GDP, also reported 10% growth. Given that in Abuja alone, however, tens of thousands of homes, and hundreds if not thousands of businesses were bulldozed, if these losses were accounted for, construction would show a net loss.

Informal Woes

¶11. (C) Like those who lived in the bulldozed homes, not counted against Nigeria's official construction figures, most Nigerians earn their living in the informal economy that makes up the larger if unaccounted, part of the non-oil sector. For these people, the booming bits of the formal economy did not have much positive spillover. In contrast, the formal sectors that experienced serious trouble, power and fuel supply, did spill over. Nigeria's drop in power production in 2006 and further drops in 2007 hit not just the formal manufacturing industry, but seriously hurt small urban businesses, from food vendors, to tailors, to small appliance repairmen, reducing demand for their products, their productivity and even the hours they could work. Even those with generators were faced with higher costs and fuel shortages impacting their earnings and raising transport costs. These two problems made life more miserable for both poor and middle class Nigerians.

Power and fuel: Bellwether Sector

¶12. (C) Nigeria produces less than 30 kilowatts per person,

not enough to power one light bulb per inhabitant. Without greatly increasing power production neither the formal nor the informal non-oil sectors can grow. The GON is making large investments in the power sector, where production is now less than at independence, but success depends on improving political stability to secure fuel supply lines, managing construction contracts cleanly, and a sound tax and regulatory regime. Nigeria also needs reliable supplies of natural gas and refined oil products; areas again where actions have been taken but have not shown concrete improvements to date. Without success in these two areas, three good years of non-oil growth is likely to be a blip rather than a sustainable trend.

Other Challenges

¶13. (C) Both the macroeconomic stability achieved and the anticipated power production increases are necessary but not sufficient to achieve sustainable broad-based growth. Nigeria also needs to improve social services. Poor health and educational attainment are barriers to growth. With 140 million people and high unemployment, Nigeria suffers a striking skills shortage. Oil companies need to import large numbers of skilled laborers. Foreign investors report chronic difficulty finding qualified staff. One company told us that for a new project they interviewed 100 people to find four drivers and had to fire two within a month. Only half of children are in school, over half of school leavers fail their exams, and the disease burden is high. For a country with a proud educational tradition it is a tragedy that keeps Nigerian families from improving their lives and a source of growing political dissatisfaction. The outlook for the future is clear: economic reforms can do only so much if Nigeria does not invest in its human capital.

¶14. (C) Environmental degradation is a further potential barrier to Nigeria's growth. Increased desertification threatens livelihoods in the North, while pipeline sabotage creates devastating environmental damage not just in the Delta but along supply routes for gas and refined products. Pipeline vandalism is a symptom of the breakdown in law and order, another obstacle for improving the welfare of Nigerians. These problems boost the misery factor today and reduce the potential impact of otherwise well-founded economic reforms in the future. Improving social services and addressing environmental and law and order problems depend crucially on improving state and local government.

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Still Vulnerable

¶15. (C) Both Nigeria's headline macroeconomic reforms and the sustainability of broad economic growth remain highly vulnerable to oil prices. Nigeria's leaders have quickly internalized today's high oil prices as the norm, even characterizing \$60 a barrel as okay, but a bit low. The reference price for oil in the budget has increased each year, and the Excess Crude Account is now shrinking rather than growing. A fall in oil prices could see budget discipline abandoned, a rapid increase in foreign borrowing, and an eventual pull back in government spending especially on the capital account, risking unfinished projects, with money spent resulting yet again in no return to Nigeria's welfare. While Nigeria is objectively better off today, most Nigerians do not feel better off. Receding oil prices could leave Nigeria even further behind. To reduce this vulnerability and to sustain reform, the next government needs to demonstrate that it can deliver power, roads, and better social services, and it can't afford to take eight years.

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